



Section 409A Reference Guide

On April 10, 2007, final regulations on deferred compensation plans (as defined under Internal Revenue Code Section 409A) were issued. This guidance is extensive (397 pages) and generally consistent with what was expected. These final regulations add another layer of guidance to Section 409A and are generally similar to prior guidance issued. Flexibility continues to be allowed in designing deferred compensation plans, helping to ensure their continued effectiveness in supplementing qualified plan retirement income for highly compensated employees.

Rely on the Principal Financial Group® to give you an edge in understanding how Section 409A affects deferred compensation plans. Following are key provisions of these final regulations.

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Plan types

Q1. What plan types are described in the final regulations and why is this important?

A. The final regulations describe the following plan types: 1) elective deferral account balance plans; 2) non-elective deferral account balance plans; 3) non-account balance plans (generally defined benefit plans funded with employer dollars); 4) split dollar life insurance plans; 5) expense reimbursement plans; 6) stock rights plans such as stock appreciation rights, discounted stock options or other equity-based arrangements; 7) separation pay or severance arrangements; and 8) amounts deferred under any other type of plan.

There are several applications of the regulations where plan types are important to plan participants. One very important application is the plan aggregation rules. For instance, if an employee is a participant in two types of account balance plans (as might occur when an employee is promoted to a new job level with a different plan), and a 409A non-compliant event occurs in one of the plans, then for taxation purposes, the plan balances of both account balance plans are aggregated to determine the amount of tax, tax penalties, and interest that is due.

Another important application of the plan-type rules in the regulations relates to plan sponsor discretionary plan terminations. A plan may only be terminated at the sponsor's discretion provided that all arrangements of the same plan type are terminated with respect to all participants, in addition to meeting other requirements. A plan sponsor may not adopt a new arrangement of the same plan type and for the same participants for a period of three years following the date of termination of the arrangement.

Q2. What specific plans are and are not impacted by Section 409A?

A. Due to a very broad definition of deferred compensation, plans generally covered include:

- Nonqualified deferred compensation plans – excess plans, 401(k) mirror plans
- Nonqualified defined benefit deferred compensation plans – SERPs
- Section 457(f) plans
- Equity compensation awards with provisions for additional deferral of compensation
- Severance agreements
- Post-retirement compensation reimbursement arrangements
- Certain split dollar plans that include a deferred compensation promise by the employer
- Discounted stock options & stock appreciation rights (see Questions 55-59).

Plans that are exempt from Section 409A include:

- Qualified plans
- 457(b) plans
- Tax-deferred annuities
- Simplified employee pensions
- SIMPLE plans
- Section 501(c)(18) trusts
- Welfare benefit plans (vacation leave, sick leave, compensatory time, disability pay and death benefit plans)
- Short-term deferrals (see Question 3)
- Equity compensations awards issued at fair market value, with no provisions for additional deferral of compensation
- Any plan described in section 415(m)
- Broad-based foreign retirement plans that meet specified criteria

Q3. What are “short term” deferrals and why are they important?

A. Generally, under an exception to the definition of deferred compensation in the regulations, a deferral of compensation does not occur if a deferred payment under the plan is made to the participant no later than the 15th day of the third month following the end of the participant’s tax year in which the right to the payment is no longer subject to a substantial risk of forfeiture. Under the appropriate business circumstance, some plan sponsors may choose to take advantage of this narrow exception.

Deferred compensation – deadlines & transition rules

Q4. What is the impact of not achieving written plan compliance by December 31, 2007?

A. If a plan sponsor does not update its plan to a position of written compliance prior to January 1, 2008, then the plan will be in violation of Section 409A. Plan participants will likely face income tax liabilities, including tax on their entire account, a 20% penalty tax and potential interest penalties, which could result in an account balance loss in excess of 60%. For example, if a participant has a current account balance of \$500,000 heading into 2008, and there was a compliance plan failure, then \$200,000 in current tax would be due (40% combined state and federal marginal tax rate times the entire account balance), plus an additional \$100,000 tax penalty (20% times the entire account balance). In addition, an interest penalty would also apply which is assessed beginning at the point when a deferred amount was added to the account balance.

It is important to note that if a plan compliance failure occurs within the elective deferral account balance plan, but the non-elective deferral account balance plan is compliant, then only benefits in the elective deferral account balance plan will be subject to taxation and penalties under the 409A rules.

Q5. What are the primary sources of transition relief?

A. Notice 2005-1 provided initial transition relief, followed by proposed regulations, and Notice 2006-79.

Q6. Did the final regulations extend the transition relief?

A. No, full documentary and operational compliance is required as of December 31, 2007. This full compliance date was previously provided in Notice 2006-79.

Q7. What transitional relief is available through December 31, 2007?

A. A plan adopted on or before December 31, 2007, will not be treated as violating 409A distribution, acceleration of benefit, or election of benefit rules if the plan is operated through December 31, 2007, in reasonable, good faith compliance with the provisions of Section 409A and applicable IRS guidance. The plan must be amended on or before December 31, 2007, to conform to the provisions of Section 409A and the final regulations with respect to amounts subject to Section 409A.

Also, for amounts subject to 409A, a plan may provide, or be amended to provide, for new payment elections on or before December 31, 2007, with respect to both the time and form of payment of such amount, without complying with the new 409A rules for such changes. This transition rule does not permit the deferral of amounts that would otherwise be payable in the tax year the election is made. Similarly, an election may not accelerate payment into the tax year that the election is made.

Q8. What is meant by the phrase “operate in reasonable, good faith compliance?”

A. In general, reasonable, good faith compliance means that plan sponsors must operate their plans in a manner which, in their best judgment, is consistent with 409A and guidance issued under that code section. A plan will not be operating in good faith compliance if the plan sponsor exercises discretion under the terms of the plan, or if a plan participant exercises discretion with respect to his or her benefits in a manner that causes the plan to fail to meet the requirements of Section 409A.

For the remainder of 2007, plan sponsors must operate non-updated plans in reasonable good faith compliance with existing guidance. Beginning January 1, 2008, the expectation of reasonable good faith compliance with transition guidance shifts to the requirement of written plan compliance with the final regulations

Q9. Under what circumstances do the 409A final regulations allow a plan sponsor to terminate a compliant plan?

A. There are three circumstances where a plan sponsor may terminate a plan: 1) corporate dissolution or bankruptcy (as ordered by the bankruptcy court); 2) upon a change in control; or 3) purely as a matter of employer discretion.

If termination occurs as a matter of plan sponsor discretion, distributions to plan participants may not begin for 12 months after plan termination and must be fully completed before the end of 24 months from plan termination. In addition, the plan sponsor will not be allowed to start a new plan of similar design until three years from plan termination have passed. For example, if an executive committee of a plan sponsor decides for cost or administrative convenience reasons to terminate an account balance plan, a new account balance plan could not be installed for three years. However, a non-account balance plan, such as a defined benefit plan, could be installed immediately since it does not have a similar design. The final regulations provide that a discretionary plan termination and liquidation will not qualify for this exception if it is proximate to a downturn in the financial health of the employer.

Q10. Is the termination of a fully compliant plan under any of the above three circumstances considered a prohibited acceleration of benefits?

A. No. Terminations consistent with the above circumstances are permissible.

Q11. What plan benefits are grandfathered from application of the rules of Section 409A?

A. Grandfathering is available for benefits earned and vested prior to 2005 if the plan participant has a legally binding right to such benefits, unless the agreement is materially modified after October 3, 2004. Post-2004 earnings on grandfathered benefits are also grandfathered. Any benefits vesting after 2004 are subject to the rules of 409A. Grandfathered amounts should be tracked separately from non-grandfathered amounts. Special grandfathering rules apply to stock option, stock appreciation rights and similar compensation plans.

Q12. What does the phrase “amounts subject to 409A” mean within the framework of recently provide guidance?

A. “Amounts subject to 409A” generally refers to those vested amounts in a deferred compensation plan that were not earned and vested as of December 31, 2004. In addition, grandfathered benefits that were earned and vested as of December 31, 2004, may become subject to 409A if the plan providing those benefits is materially modified after October 4, 2004.

Q13. What are the consequences of terminating a grandfathered plan after 2005?

A. If a grandfathered plan has termination procedures within the plan document and the plan is terminated under these procedures, the termination should not be considered a material modification. However, if the grandfathered plan doesn't have termination procedures within the plan document, or if the procedures are not followed, plan termination will be considered a material modification and the plan termination must meet 409A rules for plan terminations (see Question 9).

Q14. Do the Section 409A final regulations require that deferred compensation arrangements be documented in writing?

A. Yes, an employer-sponsored plan containing deferred compensation benefit promises must be in writing to comply with Section 409A. Written plan documents, at a minimum, must include:

1) amounts being deferred (or the formula for determining amounts deferred); 2) the time and form of payment (including the six-month delay for payments to public company key executives due to separation of service); 3) conditions for initial deferral elections; and 4) conditions for subsequent deferral elections. The final regulations also clarify that these requirements do not have to be in one document. (For example, deferral election forms may be separate documents from the plan design document). It is important to understand that all documents associated with the plan must comply with the requirements of 409A. For example, a deferral election form must comply with the deferral election rules of 409A.

Q15. Under what set of circumstances or fact patterns should a promise be reduced to writing in a form that is compliant with Section 409A?

A. Certain executive benefit and business transfer planning arrangements financed with life insurance in wide use today may unintentionally create a deferred compensation promise that now needs to be properly documented. Failure to properly document these promises could cause the deferred compensation promise/plan to be out of compliance with Section 409A. The result is that plan balances will be exposed to tax, penalties, and underpayment interest, whenever the promise is no longer subject to a substantial risk of forfeiture.

The following is a possible listing of those arrangements: 1) certain split dollar arrangements as discussed in Questions 48-54; 2) split ownership, bonus arrangements where an employee is the recipient of an implied promise by the employer as to an expectation of increased policy ownership over time as the employer's interest in the policy decreases (Principal Life does not support this form of split policy ownership); 3) key person life insurance whereby there is an understanding the life insurance policy will be distributed to a key employee (including an owner-employee) as compensation at some point in the future; and 4) severance pay plans that do not meet certain conditions outlined by the IRS in the final regulations. It is advisable for a client's legal advisor to review these agreements and plan practices to make sure no documentation for 409A purposes is required.

Q16. What changes have the regulations imposed on W-2 reporting?

A. Generally, Section 409A requires plan sponsors to report: 1) all amounts deferred under a nonqualified deferred compensation plan during the year (plus earnings); 2) any amounts includable in the gross income of a participant due to a violation of Section 409A on a Form W-2.

IRS Notice 2005-94 suspended this reporting requirement for 2005. IRS Notice 2006-100 further suspended reporting for deferral amounts ((1) above) for 2006, but requires reporting for 2005 and 2006 of amounts included in gross income. In the preamble to the final regulations, the IRS indicated that it will issue additional guidance related to these reporting requirements, including methods for calculating both the amount of deferral for a year, and the amount required to be included in gross income under 409A. Further IRS guidance, including possible transitional guidance for 2007, will address these issues.

Q17. What should plan sponsors consider and take action on?

A. Identify and review plans impacted by Section 409A. Because of the new expanded definition of deferred compensation, financial professionals and plan sponsors need to think broadly when considering plans impacted by Section 409A and the subsequent guidance. Examples of the plans impacted include:

- Nonqualified deferred compensation plans (excess plans, 401(k) mirror plans)
- Nonqualified defined benefit deferred compensation plans (SERPs)
- Equity compensation awards with deferral provisions
- Certain severance agreements
- Certain post-retirement compensation reimbursement arrangements
- Executive benefit plans, such as certain split dollar arrangements, which also include an element of deferred compensation typically through a promise by the employer to forgive amounts owed by the employee

Avoid material modifications that affect “grandfathering.” Material modifications to existing plans after October 3, 2004, (e.g. adding a “haircut” provision or adding a more favorable vesting schedule which affects grandfathered balances) should be avoided. Unintentional material modifications can be rescinded, but must be done before the earlier of 1) the date any additional right granted under the modification is exercised, or 2) the end of the calendar year in which the modification was made. Contractual restraints on the part of plan sponsors to limit amending an existing plan might be a consideration, particularly with respect to vested deferred amounts.

Document the use of transition relief provided in IRS Notice 2005-1 in 2005. If transition options below were utilized in 2005, then plan documents and board resolutions should document the use of transition relief. Election forms used for 2007 deferrals may also need to be updated for 2008 deferrals. Other actions requiring documentation include:

- Termination of a grandfathered plan with full distributions made in 2005
- Plan participants were allowed to make new 2005 deferral elections by March 15, 2005
- Plan participants are being allowed to revoke or cancel 2005 deferral elections
- With respect to non-grandfathered plans (those started since January 1, 2005), termination of the plan with distribution of all amounts under the plan occurring by the end of 2005
- Amending a plan so that it falls under an exception defined in the proposed regulations, such as the short-term deferral or separation pay exceptions

Section 457(f) plans require special attention. It’s important to notify clients with 457(f) plans that they must now meet requirements under both Sections 409A and 457(f). An improperly drafted 457(f) plan that is not compliant with Section 409A may fail to provide ongoing tax deferral and could also face tax penalties and interest. It is important that 457(f) plans be reviewed to help ensure that vesting does not unintentionally occur prior to retirement. In addition, 409A guidance indicates that 457(f) plans will not be allowed to rely on a series of re-deferrals beyond employment or non-compete agreements to maintain a risk of forfeiture during retirement.

Finalize 2008 plan election changes for plan sponsors and participants.

Plan sponsors:

Determine plan changes specific to deferral elections and distribution rules. Ensure that all enrollment, deferral election, and other plan forms are updated to reflect these changes, including performance-based compensation considerations. Ensure that updated, written plan documents are in place by December 31, 2007, (see Question 23).

Plan participants:

Make changes to payment elections for pre-2008 amounts subject to 409A no later than December 31, 2007, (see Question 23).

Conduct a Section 409A “capabilities audit” of plan administrators. Given the flexibility and requirements of the new regulations, it’s important to ensure that plan administrators have upgraded their systems with the necessary changes. In particular, it is critical that plan administrators have the capability to separately track grandfathered benefits if it is determined that such benefits are to be maintained. Ask each plan administrator which elements of the new regulations it plans to support (rabbi trusts, types of distribution and forms of payment), the corresponding timeframe and when it plans to issue updated written plan documents.

For public companies: Account for key employees. Publicly traded companies need to document key employees to comply with new rules which require a delay in payments to key employees for six months after separation from service.

Establish new deferred compensation plans. Many plan sponsors considering these deferred compensation benefits have been waiting for clarification before implementing new plans. Now is the best time to help reassure them that the best practices have been codified as part of the recent IRS detailed guidance.

Flexibility

Q18. When are deferral elections required for newly eligible participants in a new or existing deferred compensation plan?

A. First-year deferral elections must be made within 30 days of eligibility to participate in the plan. Available elections include:

- Annual deferral election (salary)
 - For services performed after the date of the election
- Performance-based deferral election
 - Calculated on a pro-rata basis being the number of days left in the performance period after the date of the election, over the total number of days in the performance period

Q19. What distribution events are allowable under the new rules?

A. No distributions earlier than one of the six specified events:

1. Separation of service, including retirement (delayed payment for key employees of public companies)
2. Death
3. Disability
4. Specified time or pursuant to a fixed schedule (like college education)
5. Change of ownership
6. Unforeseeable emergency

Q20. When should a participant make elections regarding the form of benefit payments under a deferred compensation arrangement?

A. Participant elections as to the time and form of payment upon the occurrence of a benefit event generally must be made at the same time as the election to defer the compensation. With respect to time and form of payment, the final regulations provide that a single time and form must be designated for each payment event and continue to permit a different time and form of payment for each benefit event. Changes to the time and form of payment after the initial election has been filed are possible, but payments are generally deferred for five years from the original payment date. See Question 21 for more details.

For the rules related to form of payment elections for non-account balance plans, such as defined benefit plans, see Question 44.

Q21. Can the form of payment be changed?

A. A change in the form of payment – different from what the participant selects at the time of initial deferral election – is allowed if:

- The change takes effect 12 months or later from the date the change is made,
- The date of payment is deferred at least five years, and
- For payments at a specified time or pursuant to a fixed schedule, the change is communicated at least 12 months before the date the participant is scheduled to receive the first payment.

Q22. Can an employer retain discretion as to the time and form of payment?

A. In situations where the employee has either not made an election or is not given the opportunity to make an election, the employer may set the time and form of payment. However, the employer must make the election no later than the employee's elections would have been irrevocable. There are many existing SERP agreements which allow the employer the "sole discretion" as to whether the payment is made as a lump sum or as installment payments. While the employer is making the decision, future changes are still subject to the subsequent deferral rules.

Q23. Can the timing of payments be changed?

A. A deferred compensation payment may not be accelerated unless allowed by the exceptions listed in the guidance. An existing plan may be amended to provide new timing and payment elections for amounts subject to 409A. New payment elections can be made through December 31, 2007, with respect to both the time and form of payment. However, new elections cannot affect amounts that would otherwise be received by the plan participant in 2006 or 2007. A plan participant may otherwise extend the deferral period by making a proper election 12 months before the effective date and must extend the deferral period for at least five years.

Example: Original separation from service distribution election is in the form of a lump sum. A change in form (made more than 12 months before separation from service) to 10-year installment would allow the installment to start five years after the original distribution date.

Q24. How might the “five-year deferral rule” apply to subsequent changes in the time and form of payments under various scenarios?

A. The final regulations generally permit each separately identified amount to which a plan participant is entitled on a determinable date to be considered a separate payment. A change in the time or form of one separate payment need not impact any other separate payments.

A single installment payment from a stream of payments for a fixed period of time is generally treated as a “separate payment” for purposes of the five-year deferral rule. However, a plan may specify that a series of installment payments be treated as a series of separate payments thereby changing the application of the five-year deferral rule. For example, if a five-year installment payment is treated as a single payment and is scheduled to commence on July 1, 2010, then a participant could change the time and form of payment to a lump sum payment on July 1, 2015, or later – provided the other conditions related to a change in the time and form of payment are met. In contrast, if a five-year installment payment is designated as five separate payments scheduled for the years 2010 through 2014, then if the participant changed the form of payment to a lump sum, he or she could not receive a single payment with respect to all of the previously elected installment payments before 2019 (five years after the last of the originally scheduled payments). On the other hand, a single installment payment may be deferred five years with the balance of the payments paid as originally scheduled if the plan calls for installment payments to be treated as separate payments.

One exception to the above rule is a life annuity – the entitlement to which is always treated as a single “separate payment.”

The final regulations also address multiple potential payment events and possible multiple forms of payment. For example, a plan may provide that a participant is entitled to an annuity at age 65 or, if earlier, a lump sum payment upon separation from service. The five-year deferral rule would apply separately to each payment event. Accordingly, the employer generally would be able to delay the annuity payment date from age 65 to at least age 70, but keep unchanged payment of a lump sum upon separation from service before age 70.

The final regulations also permit an intervening event that is a permissible payment event under 409A to override an existing payment schedule already in payment status. For example, a plan could provide that a participant would receive six installment payments commencing at separation from service, but also provide that if the participant died after payments commenced, all remaining benefits would be paid in a lump sum.

Q25. Can an employer amend an existing deferred compensation plan to allow for certain payment events?

A. Final regulations provide that the plan may be amended to include death, disability or an unforeseeable emergency as potentially earlier payment events. If the addition of these payment events delays the payment (a “later of” event), the subsequent deferral elections apply. For example, an employer may not add death as a payment event to a plan including a fixed date as the payment event such that the new payment event would be the later of the fixed date or death.

The addition or substitution of a specified date, fixed schedule, a change in control event or separation of service payment events may not accelerate payments and must meet the requirements of subsequent deferral elections as addressed in Question 21.

Q26. When will a payment be made to the participant if one of two events or more permissible events has occurred?

A. A plan may provide for a different form of payment for each type of permissible payment or the plan may provide that payments will be the earlier or the later of the specified payment events. For example, a plan participant may be entitled to an annuity at age 65 or, if earlier, a lump sum payment upon separation of service.

Q27. Can an employer implement a deferred compensation arrangement for compensation received annually based on incentive or performance criteria?

A. Yes, the employer may sponsor a plan that allows the participant to defer performance-based compensation. The employer has 90 days after the beginning of the service period to establish the criteria to determine the compensation. The plan participant may defer this compensation as long as the election is made no later than six months before the end of the period and before the amount is readily ascertainable.

Q28. Is a publicly traded company subject to special rules for its deferred compensation arrangement?

A. Payments to key employees of a publicly traded corporation must be delayed at least six months following the separation of service. The final regulations provide clarification when the publicly traded company identifies those people who are key employees. Generally, the corporation will identify those employees based upon a 12-month period ending on a date determined by the publicly traded corporation. For example, the corporation may choose December 31 as the identification date. Any key employees identified during the calendar year ending December 31 would be treated as key employees from April 1 and 12 months thereafter.

Q29. Does every company need to name key employees in order to comply with the new distribution rules?

A. No, only public companies with deferred compensation plans need to identify their key employees for purposes of the new distribution rules. Nonpublic, closely held businesses do not need to identify their key employees. The proposed regulations impose a six-month waiting period before nonqualified deferred compensation plan distributions can begin to a key employee following separation of service.

Key employees are those employees as defined in IRC 416(i). Under this definition, key employees are generally employees who are 1) officers with annual compensation of \$145,000 (for 2007), 2) a 5% owner, or 3) a 1% owner with annual compensation greater than \$150,000. An employee is a key employee if any of the above conditions are met within the 12-month period ending on the identification date.

Generally, December 31 will be used as the identification date unless the employer elects to use a different date and that date is used consistently. Key employees are subject to the six-month delay in distributions upon separation from service occurring during the 12-month period, which starts on the first day of the fourth month following the identification date.

Q30. How are the rules applied when an employee participates in multiple arrangements?

A. The final regulations expanded the categories of plans. The categories include account balance (defined contribution) plans, non-account balance plans (defined benefit), separation pay arrangements, split dollar life insurance arrangements, reimbursement plans, stock rights and foreign income plans. In addition, the account balance (defined contribution) category was subdivided into elective plans and non-elective plans. All amounts under each category will be considered one plan. These provisions are applied on an individual participant basis. It is critical to specify, in writing, when and how payments will be made in multiple arrangements to avoid a violation of Section 409A.

Material modification

Q31. What is a material modification?

A. Under the regulations, a material modification is adding a new benefit or right to the plan or an indirect or direct enhancement of a right or benefit existing as of October 3, 2004. Material modifications may occur in the form of a plan amendment or as an exercise of the service recipient's discretion under the terms of the plan. For instance, an amendment that extends the time and form of payment of a grandfathered amount would be considered material.

It is not a material modification of the plan to exercise discretion, for example, over the time and manner of benefit payment to extent such discretion is provided under the terms of the plan. In addition, the reduction of an existing benefit is not a material modification. Also exempted is the addition of a limited cash-out feature which meets certain other requirements in the regulations.

Q32. Do the final regulations change the grandfather rules included in Notice 2005-1?

A. No. Under Notice 2005-1, earned and vested benefit liabilities existing on December 31, 2004, may be grandfathered. This means all such amounts and their earnings fall inside existing plan provisions and are not covered under Section 409A. This can be particularly attractive for plans providing more liberal provisions, as they do not now have to be covered under 409A. Grandfathered benefits retain this status for the life of the plan, unless the plan is materially modified. For this reason, it is extremely important to track these benefits separately to maintain attractive features such as 'haircut' withdrawals. Benefits accruing after December 31, 2004, are treated as outside the existing plan and are subject to the new 409A rules.

Q33. Is it possible for grandfathered benefits to lose their grandfathered status?

A. Yes, if the plan is materially modified after October 3, 2004, then this special grandfathered status is lost and all plan benefits of the same plan type are subject to Section 409A.

Q34. Do the final regulations provide any relief from an inadvertent material modification?

A. The consequences of an inadvertent material modification can be significant given the amounts of compensation and earnings that can be deferred under a grandfathered plan. Consequently, the final regulations allow an unintentional material modification to be rescinded if acted upon by the earlier of the date before the right granted under the modification is exercised or the last day of the calendar year during which the change occurred.

Coordination with qualified plans

Q35. How do the final regulations affect nonqualified deferred compensation plans that are “linked” to qualified plans (also known as “wrap” or “pour-over” plans)?

A. Typically, the purpose of a linked nonqualified deferred compensation plan is to replace the benefits that would have been provided under a qualified plan, absent certain limits contained in the Code. The final regulations generally adopt rules under which nonqualified deferred compensation plans linked to qualified plans may continue to operate. However, the guidance only provides relief to the extent that affected deferrals do not exceed the maximum amounts that could have been electively deferred in the qualified plan under section 402(g). In 2007, the 402(g) limit is \$15,500. The final regulations clarify that application of the age 50 catch-up provisions are also available.

Q36. If a nonqualified deferred compensation plan is linked with a qualified plan, will an amendment to the benefits under the qualified plan result in a deferral election or an acceleration of benefits under the nonqualified deferred compensation plan?

A. The final regulations generally provide that an amendment to increase or decrease benefits under the qualified plan will not be treated as an impermissible deferral election or an acceleration of benefits under the linked nonqualified deferred compensation plan.

Q37. What is an example of how the new rules apply to a nonqualified deferred compensation plan that is linked with a qualified plan?

A. *Example:* Under the terms of an arrangement, employee elects on or before December 31 to defer compensation into a nonqualified deferred compensation plan which is linked with a qualified plan. As of the earliest date administratively practicable following the end of the year in which the salary is earned, the maximum amount that may be deferred under the qualified plan is credited to the employee’s qualified plan account, after being reduced for nondiscrimination testing. The participant’s account in the nonqualified deferred compensation plan is reduced by the corresponding amount at that time.

Section 457

Q38. Does Section 409A apply to 457 plans?

A. Section 457 provides special deferred compensation rules for not-for-profit entities and state/local governments. “Eligible” 457 plans must meet the annual deferral limits and other requirements of Section 457(b). These plans are not subject to 409A. Plans that do not meet the requirements of 457(b) will be considered “ineligible” 457(f) plans and are generally subject to 409A.

Q39. Generally, what income tax rules apply to ineligible 457 plans?

A. The income tax framework of an “ineligible” 457 plan is outlined in Section 457(f) and the accompanying regulations. Generally, plan benefits are included in the participant’s gross income in the first taxable year during which the employee’s right to the benefit is not subject to a “substantial risk of forfeiture”. In other words, vesting of any portion of a plan benefit will cause such vested amount to be immediately taxable, even if the benefit is not paid to the participant.

Any plan failure under Section 409A also causes vested benefits to be taxable and subject to a possible 20% tax penalty, to the extent such income has not been previously included in gross income.

Q40. How does Section 457(f) interact with Section 409A?

A. The rules for determining taxable income under Section 457(f) and Section 409A are generally independent of each other and income may be recognized under either Code section. However, the same plan benefits will not be taxed twice. Income is recognized under Section 409A only to the extent not previously recognized under Section 457(f), for example. Similarly, income will be recognized under Section 457(f) only to the extent not previously recognized under Section 409A. The plan administrator of an ineligible 457 plan will need to be aware of and administer the plan based on both sets of rules.

The final regulations provide that income attributed to a vesting event under 457(f) is generally exempt from coverage under 409A by the short-term deferral rules (see Question 3). However, amounts not paid to the plan participant prior to the 15th day of the third month following the later of the end of the participant’s taxable year or the end of the employer’s taxable year in which the amounts deferred (including earnings) are no longer subject to a substantial risk of forfeiture. Therefore, if a participant is taxed due to a vesting event, but the full amount of the benefit is not distributed within the short-term deferral timeframe, then earnings on vested benefits retained by the employer will be subject to the 409A final regulations.

Q41. What happens if an employee vests in plan benefits under an ineligible 457 plan prior to the normal time for distribution of benefits?

A. An ineligible 457 plan may be drafted in a manner which permits a payment acceleration to a participant to the extent necessary to pay federal, state, local and foreign income taxes due on a plan vesting event. The 409A final regulations consider such plan provisions as a permissible acceleration. This feature of the regulations is intended to help an employee who must recognize taxable income upon a vesting event, where no payments, or partial payments, are made concurrent with the vesting event, by allowing access to a source of funds to pay taxes associated with the income recognition.

Defined benefit plans

Q42. How is the grandfathered amount of a nonqualified defined benefit plan determined?

A. Benefits earned and vested as of December 31, 2004, may be grandfathered. This can be attractive since grandfathered benefits generally are not covered under 409A. The regulations provide that the grandfathered benefit is equal to the present value of the benefit the participant would be entitled to receive if he or she voluntarily terminated services on December 31, 2004, and received benefits on the earliest possible date allowed under the plan.

Q43. If a plan allows optional forms of benefit distribution, are these elections subject to rules under Section 409A?

A. Yes. Many plans permit participants to select a different distribution method, with an equivalent present value, as an alternative to the normal form of benefit payment. Under the proposed regulations, the election of an optional form is considered to be a change in the time and form of the benefit payment. This means a participant needs to make a proper election 12 months before the benefit start date and must delay the benefit start date for at least five years.

However, the regulations also contain an exception for changes between life annuity forms for payment. An election from one life annuity to another life annuity (e.g. from a single life annuity to a joint life annuity) is not considered a change in time and form of payment so the 12-month filing deadline and five-year payment extension delay are not required. But an election to change from a life annuity to a non-life form of payment (e.g. lump sum or fixed period of installments) does not qualify for this exception and must comply with the rules above.

Q44. When does a form of payment benefit election need to be made under a nonqualified defined benefit plan?

A. Distribution elections by plan participants must be made at the time of plan participation. Newly eligible plan participants must make their distribution election within 30 days of eligibility from entry into the plan. Under the transition rules, an existing plan may permit participants to change their form of payment for benefits subject to 409A as long as the election is completed by December 31, 2007.

Q45. How do the final regulations affect distributions under nonqualified defined benefit plans that are linked to qualified pension plans?

A. The purpose of a nonqualified defined benefit plan linked to a qualified plan is to replace the benefits that would have been provided under a qualified pension plan, absent certain limits contained in the Code, such as the section 401(a)(17) compensation limit. Typically, the time and form of benefit payment under the nonqualified plan is controlled by the time and form of payment chosen under the qualified plan. The final regulations **did not** extend favorable transition grandfathering provided first under Notice 2002-8, and extended under the 2005 proposed regulations.

This grandfathering allowed linkage of plans to continue through 2007 without requiring compliance with Section 409A payment distribution rules. Beginning January 1, 2008, these plans must follow the time and form rules of 409A, meaning separate distribution elections need to be made for the nonqualified plan. Keep in mind, other provisions of the Code and common law tax doctrines, such as constructive receipt, continue to apply.

Q46. For linked nonqualified plans, do changes in the linked qualified plan benefit result in deferral modifications or impermissible payment accelerations under the nonqualified plan?

A. No. Qualified plan contributions may change as a result of the benefit and compensation limitations imposed under the Internal Revenue Code. Benefit accruals may also change due to amendments in the qualified plan. Such changes cause benefits under the linked nonqualified plan to increase or decrease. The regulations generally adopt the principle that such changes are not considered additional deferrals (if the nonqualified benefit increases) or payment accelerations (if the nonqualified benefit decreases).

Q47. Are there new informational reporting requirements for nonqualified defined benefit plans?

A. Yes. Section 409A requires that benefit accruals for nonqualified defined benefit plans be reported on IRS Form W-2. This reporting is for informational purposes only and does not affect the taxability of these amounts. These reporting requirements have been suspended for 2005 and 2006. Since the IRS recognizes these accruals may be difficult to compile for reporting purposes, the Treasury and IRS have indicated they intend to offer additional guidance on this topic.

Split Dollar

Note: Split dollar arrangements are complex plans that require analysis of the plan in light of all relevant tax guidance, including split dollar final regulations issued in 2003 and grandfathering treatment under Notice 2002-8. Clients should consult knowledgeable tax counsel for an analysis of their plan.

Q48. Is IRC Section 409A applicable to split dollar arrangements?

A. Final split dollar regulations, issued in September 2003, address taxation of split dollar plans. There may, however, be a deferred compensation promise written into the split dollar agreement. In general, depending upon the nature of the deferred compensation promise, such a promise may be subject to Section 409A.

Q49. Under what circumstances will a split dollar arrangement be considered deferred compensation subject to Section 409A?

A. The Treasury and IRS published Notice 2007-34 at the same time the 409A final regulations were released. This notice provides guidelines under which certain features of split dollar arrangements may be considered deferred compensation subject to the 409A

final regulations. In general, split dollar arrangements where a plan participant has a legally binding right to a future payment from the employer under the split dollar plan, will give rise to coverage under 409A. The most common forms of these future payments generally occur in equity endorsement plans where some or all of the cash value is promised to the plan participant and has not been previously taxed, or under a collateral assignment form of split dollar where the employer plans to forgive its premium advances or loans.

According to Notice 2007-34, split dollar arrangements providing **only life insurance death benefits** generally are not subject to the Section 409A final regulations. This appears to be true for both traditional endorsement split dollar plans and non-equity collateral assignment split dollar arrangements taxed under the economic benefit rules. Endorsement arrangements providing only life insurance death benefits are frequently used as an additional employer-sponsored benefit along with a nonqualified deferred compensation plan.

“Equity” endorsement split dollar arrangements, where a participant has been promised a portion of the policy cash value which exceeds the owner’s interest in the policy, are generally subject to Section 409A. This will generally be true if the participant has a legally binding right to a future payment from the employer based on the split dollar agreement and the participant has not been previously taxed on the promised benefits. Arrangements where a non-owner has been taxed annually on cash value increases due to “current access” to policy values, will generally not be subject to 409A since the participant is taxed each year on the amount of the benefit.

Notice 2007-34 provides a safe harbor method of determining what portion a policy’s cash value may be earned and vested after December 31, 2004. Benefits under such an arrangement which are earned and vested prior to this date are generally grandfathered from coverage under 409A, unless the arrangement is materially modified. It should be pointed out that equity endorsement arrangements are quite rare and have never been marketed or supported by Principal Life Insurance Company.

Notice 2007-34 also provides that collateral assignment arrangements taxed under the **loan regime** rules of IRC Section 7872 are generally not subject to 409A, unless the employer enters into a legally binding promise to not require repayment of amounts loaned.

Q50. Is the short-term deferral rule helpful to split dollar arrangements providing deferred compensation benefits?

A. Benefit payments under a split dollar arrangement that are generally subject to taxation under the provisions of Section 409A as described above, may also fit within the short-term deferral exemption of the 409A final regulations. For example, if an employer agrees in writing to not require repayment of its premium advances or premium loans, and this forgiveness event occurs within the 2½ month window for short term deferrals, then the arrangement is otherwise exempt from the scope of 409A. It is generally anticipated that most split dollar plans with built-in deferred compensation promises would qualify for the short-term deferral exception (see Question 3). We also suggest that when split dollar arrangements are reviewed for 409A purposes, it is advisable to also review the document to determine if any ERISA issues need to be addressed.

Q51. Does a grandfathered collateral assignment, equity split dollar arrangement provide deferred compensation benefits?

A. A grandfathered equity split dollar arrangement is generally drafted as a collateral assignment split dollar agreement whereby the employer pays the entire premium with the employee recognizing the economic benefit costs as taxable income. As a grandfathered arrangement, economic benefit costs may be measured by the one-year term rates of the insurance carrier issuing the split dollar policy. Upon termination of the split dollar arrangement, the employer recovers premiums advanced, unless the employer decides to forgive the repayment requirement. If the cash value of the policy exceeds premiums paid, the excess cash values will belong to the employee.

If the employer isn't obligated to make future premium payments under the facts and circumstances of the arrangement, and there is no agreement for the employer to forgive the premiums advanced, it doesn't appear that the equity component of this arrangement is considered deferred compensation by Notice 2007-34.

Q52. Does a change to a grandfathered split dollar arrangement in order to comply with 409A, or to avoid compliance by qualifying for an exception, constitute a material modification for purposes of the split dollar final regulations and Notice 2002-8.

A. Under Notice 2007-34, the Treasury and the IRS have taken the position that if a split dollar arrangement is modified to comply with Section 409A, or to avoid the reach of 409A, then such a modification generally will not be considered a material modification for purposes of Notice 2002-8 and the split dollar final regulations.

Q53. Does a standard split dollar arrangement require the employer to continue to make premium payments in a tax year after any substantial risk of forfeiture lapses?

A. Split dollar arrangements vary widely in structure. Most arrangements, however, permit the employer or employee to terminate the split dollar arrangement at any time. Agreements that do require ongoing employer premium payments are generally conditioned upon continued employment by the employee. This would likely be considered a "substantial risk of forfeiture." However, most split dollar arrangements will not require an employer to continue to make premium payments in a tax year after any substantial risk of forfeiture lapses. However, in some fact patterns, such as those involving a majority owner or a family member working in the business, it may be more difficult to demonstrate that the arrangement truly is something other than an ongoing commitment to pay premiums.

Q54. Does a standard split dollar arrangement provide for premium forgiveness or policy transfer from employer to employee?

A. Typically, the split dollar agreement itself does not include such provisions. The same life policy is sometimes used as part of both a split dollar and nonqualified deferred compensation arrangement. However, the proper means of structuring such an arrangement would be to have separate split dollar and deferred compensation agreements. The deferred compensation agreement should, of course, be compliant with Section 409A. If separate

agreements are not used, the split dollar arrangement may be considered a funded deferred compensation plan. In addition to raising income taxation issues, a funded deferred compensation plan may create ERISA compliance issues.

Stock appreciation rights (SAR) plans

Q55. Are SAR plans subject to Section 409A?

A. The final regulations generally exempt nondiscounted stock appreciation rights of company common stock from Section 409A. The SARs exemption also applies to companies whose stock is not traded on an established securities market (privately held companies). Furthermore, this exemption applies to SARs settled in stock and cash.

The final regulations provide that company stock may include stock of any corporation in a chain of organizations all of which have a controlling interest in another organization, beginning with the parent organization for which the employee was providing services at the date of the grant of the stock right. However, an anti-abuse rule has been added to address corporate structures, transactions, and/or stock right grants whose principal purpose is to avoid application of 409A.

Q56. What do the final regulations say about SAR plans?

A. SAR plans are not a deferral of compensation (and not subject to the new rules) if: 1) the compensation payable under the SAR plan is not greater than the difference between the fair market value of the stock on grant date and the fair market value of the stock on exercise date, with respect to a number of shares fixed on or before the grant date, 2) the exercise price may never be less than the fair market value of the stock on the grant date, and 3) the SAR plan does not include any feature for the deferral of compensation (other than the deferral of income recognition until the exercise of the SAR).

57. What is the fair market value of the stock if the stock is not publicly traded?

A. The IRS and the Treasury are concerned about abuse in stock valuation concerning SAR plans (especially since they are generally exempted from the new rules). As such, the final regulations require fair market value to be determined by the “reasonable application of a reasonable valuation method.”

The final regulations provide that a company (including an employee stock ownership plan) that values the underlying stock of a SAR plan based on its independent appraisal under the Code that is no more than 12 months before the relevant transaction to which the valuation is applied (ex. SAR grant date) will be presumed to result in a “reasonable valuation” (unless the participant or company could reasonably anticipate a change in control within 90 days or an initial public offering within 180 days).

The final regulations further clarify that a company may use one valuation method to establish an exercise price and another valuation method to establish the payment price. Consistency in valuation methods is not required.

Q58. Will the extension of a stock right's exercise period be treated as an additional deferral feature for Section 409A purposes?

A. If the exercise period is not extended beyond the earlier of the original maximum term of the stock right or 10 years from the original date of the grant of the stock right, the extension of the exercise period does not constitute an additional deferral feature.

Q59. What is an example of a SAR plan that would not be subject to Section 409A?

A. A privately held company grants 1000 stock appreciation rights to an employee. The value of the stock on the grant date is \$20 per share. This is based on an independent appraisal that was completed the prior month.

According to the provisions of the SAR plan, the employee may exercise the stock appreciation rights and receive the difference between the value of the stock on the exercise date and on the grant date, if the value on the exercise date (based on a reasonable valuation method) is greater. This SAR plan will generally be exempted from Section 409A provided there are no other plan provisions that are subject to 409A.



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